The 2007-2009 Financial Crisis and the Future of Finance

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The American financial system has had remarkable accomplishments. Without its effectiveness and some of its unique features, we would not have had Microsoft, Google, or the Internet. Without the pressure it placed on companies to use cash wisely, we probably would not have had the productivity acceleration of the last two decades. Without its success in providing credit to consumers, fewer Americans would own their own homes and cars, and American families would live less well than they have over the last generation.

The financial system in many ways has borne out what Walter Bagehot said in "Lombard Street": that the financial community plays a vital role in the economy by acting as "a standing broker between the quiet savings districts of the country and active employing districts."

And so there is much to be satisfied with and much to preserve.

And yet I would suggest to you that the events of the last two years are the culmination of a sequence of financial problems.

Roughly every three years for the last generation, a financial system that is supposed to manage, distribute and control risk has, in fact, been a source of risk, with devastating consequences for workers, consumers and taxpayers.

Think about it. The last generation has seen the Latin American debt crisis, the 1987 stock market crash, the S&L debacle, the Mexican financial crisis, the Asian financial crisis, LTCM and its aftermath, the bursting of the dot-com bubble and Enron, and now the financial crisis that began in 2007.

One crisis every three years.

As George Soros has noted, what is remarkable about the crisis of 2007 was that it was generated not outside the system, not from some outside force, but largely within the financial system. Its consequences are sobering. An extra 8 million people unemployed, output losses that will accumulate well into the trillions of dollars, representing over $30,000 for the average American family, not to mention the consequences around the world.

Surely we cannot be satisfied with a system that misfires so seriously so frequently; surely even as we work to rebuild confidence, we need to be thinking about the next time and making it less likely.

How to think about financial reform? For many, this crisis and its predecessors are morality tales. Lenders lent and borrowers borrowed irresponsibly. People took risks when they should have known better. Greed replaced prudence.

But this, I would suggest, is too simple a view. For one thing, human nature is relatively constant, and the frequency of crises varies substantially from era to era.

Moreover, it's not plausible to indict the morality of all or even most of the participants in any major industry.

Rather, understanding the crisis we've just been through suggests recognizing what we might call Gresham's law of behavior. Gresham's law is the proposition that under legal tender laws, currency in circulation will tend to be debased by an increasingly high ratio of notional value to commodity value. I guess that's the pretentious way of saying it. The more conventional way of saying it is that bad money drives out good money.

The broader proposition is that in competitive financial markets, without proper regulation, it becomes too difficult to reconcile profitability and prudence, resulting in imprudence driving out prudence.

Consider the consequences of the lowest common denominator dynamic that unscrupulous, imprudent or merely overoptimistic actors can set in motion.

Those who are willing to lend at too small a spread, overpay for assets, take on risk based on implicit government guarantees, operate on too thin a capital margin or mislead their customers make it impossible for others to behave prudently, responsibly and stay actively in business.

That I would suggest is an important part of what happened in the run-up to the 2007 financial crisis. Pressure from those willing to push the edge of the envelope, on all of these dimensions, made it impossible to maintain standards and continue to do business.

What followed was familiar: bad lending, inflated asset prices, the end of the bubble, changes in gestalt, panic, deleveraging, and all the consequences that we have seen.

Where do we go from here? And how best to reconcile profitability and prudence? There's a kind of standard pattern after financial crises. We've had a lot of opportunity to observe it.

Wise people furrow their brows and observe that mistakes were made, from which all can learn. The importance of counterparty discipline is emphasized. Transparency is applauded.
Managements and boards vow to do better.

There is no disagreement about the importance of ethics and of better market infrastructure. Commissions are formed. Recommendations are made. And the world moves on.

All this is constructive, to a point but only to a rather limited point, because it relies on the basically implausible premise that you can improve outcomes by improving human nature.

I think in approaching this problem it's useful to go back to an essay I read many years ago that was Daniel Patrick Moynihan's first contribution to a public policy debate. In the late 1950s, as an aide to then-Governor Averell Harriman, Moynihan approached the problem of automobile safety, which at that time was devastating.

It was his insight that at that time that the then-prevalent approach to automobile safety – better educate drivers, impress on them their duty to drive safely and seek to arrest people who drove recklessly – was both ineffective and incomplete: ineffective because the automobile fatality rate kept rising; and incomplete because it relied on trying to change human nature, rather than taking human nature as given and improve the outcomes that resulted.

Moynihan's essay went on to suggest what has been the dominant paradigm in automobile safety in the 50 subsequent years, one focused not only on drivers but on the rules of the road and on improvements in safety mechanism. It's about guard rails. It's about seatbelts and airbags. It's about speed limits. It's about shatterproof glass. It's about recognizing that there will be errors, that there will be carelessness, that what happens to one driver matters for others, and improving the consequences.

The results have been an achievement in accident reduction that we could only dream of in the financial area. Automobile fatalities per mile driven are less than a third today of what they were at the time when Moynihan wrote, even as people actually drive faster on highways. In the same way, we need approaches to financial regulation that seek to make the world safer for ignorance and cupidity, which are inevitable, rather than relying on our ability to correct them.

The key to thinking about the design of a better financial system is not seeking to make people either smarter or avaricious, nor is it to assume that somehow regulators in the future will be vastly wiser or vastly more insulated from the pressures of the communities in which they reside than they have been in the past.

This perspective has a number of implications for debates about financial reform. For example, while no one can object to gauging impending risks and giving warnings when bubbles emerge, it is the essential nature of bubbles that they involve an overly pervasive and conventional complacent wisdom. To rely on even the most able and dedicated officials embedded in an environment that comprises those they regulate, and, in a broadly political community, to be unfailing stalwarts against misguided conventional wisdom, is probably to ask too much.

Even in the annals of successful speculation, there are strikingly few examples of successful careers built on identifying bubbles and going the other way. If it were as easy as much of the commentary about early-warning systems suggests, we would probably have more success examples.

To be sure, it is easy to predict all the bubbles and all the crashes. Simply predict a crash all the time, and you will sometimes be right. But that is surely not a constructive basis for regulation.

Closely related is the broader idea that the continuing objective of making future foresight as good as recent hindsight may well be futile. Risk modeling continues to improve, but there's a serious danger in placing too much faith in attempts to improve risk management. If generals are always fighting the last war, risk managers have little to look at but past data, and may well be responding to the last crisis.

We're now in a phase marked by the emphasis on the application of good judgment based on experience rather than quantitative tools. But I would suggest to you that the root of most financial error is the attempt to do today what you wish you had done yesterday. That's what's behind the speculators who pile in at the late stages of every bubble. That's what's behind the voluntary liquidations characteristic of every trough. That's what's behind the relaxation of regulatory standards late in expansions. And that's what's behind the tightening of regulatory standards after downturns.

And so we need to be very careful about seeking to create systems that are based on our capacity to be smarter than we are likely ever to be.

This point is of course reinforced by the logic of the market. If it were ever entirely clear to all reasonable observers that an asset price was out of line, it would already have fallen.

And so to suggest that the kind of conclusive evidence will ever be available, as a basis for action, is I would suggest a misplaced hope.

What then is the right approach? The right approach, I would suggest, goes back to Moynihan's insight about the importance of making the system safe, given the realities of imperfect humanity.

It goes back to the idea of reconciling profitability with prudence and removing or at least reducing the pressure that the imprudent put on the prudent. President Obama has proposed five common-sense principles, as guiding our regulatory efforts, that seek to embody just this philosophy.

First, financial institutions must have adequate and increased levels of capital. Substantial capital requirements attenuate moral hazard problems, by ensuring that lenders are relying on capital rather than the perception of guarantee.

They reduce the ability of shareholders to rely on a “heads-I-win, tails-someone-else-loses” dynamic. And perhaps most importantly they provide a reserve, so that even when serious mistakes are made, the result is not to threaten the ability of institutions to meet their debt obligations and carry forward on systemic risk.

As Bagehot once observed, the time for economy and for accumulation of capital is before a crisis. A good banker will have accumulated in ordinary times the reserves he is to make use of in extraordinary times.

The second principle is that firms should not be able to choose their own regulator. This is integrally related to the first principle. If capital levels are to be set at high levels and are to be set at levels that protect the system, beyond what may be in the interests of any individual institution, it is necessary that they be applied broadly.

If firms are in a position to choose their own regulator, the result will be an inevitable race to the bottom. They will choose, among competing regulators, the one who sets the lowest standard. Call it charter-flipping in the United States; call it competition between state and national banks in the United States; speak of international competition.

It was not very many years ago that the United States had a comprehensive review of financial regulation, the overwhelming thrust of which was only one thing: reduction in competitive differentials with the city of London. Without commitment to regulatory harmonization, no other commitment to strengthened regulation can have any very great effect.

The third principle: If we're going to have a financial system that is failsafe, it has to be safe for failure. We could all debate – and, if there are 200 people in this room, there might well be 201 opinions – what the authorities could have done or should have done as they faced the problems at Lehman and AIG last fall.

Where there would be no debate, I would suggest, is in the conclusion that the choices the authorities had were manifestly unsatisfactory. It is wrong that taxpayers thousands of miles from Wall Street should be at risk because our systems give authorities no choice but to commit taxpayer money or to accept collapse and chaos. It is essential that we develop a means of managing the failure of financial institutions, because without the prospect of failure, it is difficult to contemplate the application of market discipline.

Fourth, any institution that is big enough and interconnected enough that its failure can bring down the financial system or threaten a crisis that would put hundreds of thousands of jobs at risk is big enough and interconnected enough that it should be subject to comprehensive regulation by an accountable regulator. This is only common sense, and yet it is not something that has been in place historically.

Fifth, and of a somewhat different order, is the need for a separate agency to protect consumers from predatory practices and to set clear rules of the road for the marketing of consumer financial products. This too comes from the logic of incentives. Yes, you can criticize the specific decisions of specific regulatory agencies in the past, in the mortgage area and in other areas. Yes, you can point to reports that were written and ignored. But in a deeper sense, any regulatory agency that has as its primary mission the soundness and profitability of the banking system or the financial system cannot be relied on to pursue objectives that are potentially inconsistent with that overall mandate with sufficient vigor.

That's why President Obama has proposed the creation, for the first time in American history, of a unified independent consumer financial protection agency with just one mission: to protect the American consumer from fraud and abuse and ensure that people get the clear information they need about loans and other financial products.

In light of the recent events in the mortgage market, the prevalence of predatory lending practices, the ubiquity of problematic practices in the credit-card market and exploitative overdraft fees, we need a regulator whose mandate is exclusively consumer protection rather than the profitability of particular financial institutions.

If we can adopt this philosophy and implement a program based on these five principles, I believe that we can create a system that is much less vulnerable than the system that we have today, and we can create a system that preserves and, indeed, strengthens the great benefits of a market-based financial system in allocating capital and permitting the sharing of risk.

A final thought. There is as large a disjunction as I can recall in the recent return to good fortune for many in the financial sector and the fortunes of a broad American middle class. On Wall Street, one hears talk of return to profitability, the end of recession and the need for exit strategies. I can assure you that on Main Street, with still-rising unemployment, it is a very different conversation.

We can explain the events of the last year in ways that are importantly correct but not satisfying. We can note that, just as in war there are unintended victims, so too in economic rescue there are unintended beneficiaries.

We can note that businesses that deserved to fail because they were unable to meet their liabilities on their own were saved by the American taxpayer, not for their own good, but for the greater good.

We can remind people that if the government had not taken the actions that it did during the past year, our situation would be far worse in the real economy, and far more Americans would be unemployed today.

These propositions are surely correct. The attempt to mount ambitious financial rescue was the right one. But to state that these actions were the correct ones is not to state that all of those who are its beneficiaries are, or were, deserving. And it is important that those in the financial sector remember that there is no major financial institution that exists today that is not the direct or indirect beneficiary of massive taxpayer support for the financial system.

This has direct relevance for the changing nature of the social compact between the financial sector and the broader economy. The time has come for fundamental changes in how financial institutions conduct their business and how they are regulated.

Consider, for example, some who have sought to oppose the creation of the consumer financial protection agency.

I am not a populist, but when I hear of institutions that received billions of dollars of assistance from the government that are in existence today because of that support – who use complicated algorithms to ensure that when people bounce checks, the checks are cashed in whatever order will maximize the overdraft fees – when those institutions complain that a Consumer Financial Protection Agency will somehow inhibit financial innovation – like those they practice with respect to overdrafts – I think it's a bit rich.

We in government have no monopoly on wisdom. These are enormously difficult and complex problems. How best to implement principles like those I've spoken of and other related ones is a subject for much debate.

But I believe we will move forward most successfully if we can at least find common ground on the proposition that a return to the status quo is unacceptable on the proposition that we are not going to eliminate either foolishness or avarice, and that ultimately, we will have a system that will work better, both for those in finance and for the vast majority of our fellow citizens who depend on finance, if we can work together to establish a new regulatory framework that permits the reconciliation of profitability and prudence.